

## The BHP-effect

By Paul Doggett

There is a very important dynamic in the Australian stock market which I call the BHP-effect. BHP Billiton Ltd (BHP) is the largest weighted stock by capitalisation in the Australian market. In January 2011 BHP Billiton Ltd (BHP) held 13.25% of the S & P ASX200 index which was almost double that of the next largest stock which is the Commonwealth Bank with around 7%.

BHP's influence over the direction of the broader market is strong because not only does BHP lead our market by sheer weight of capitalisation and also by sentiment due to the cultural heritage of the stock in the Australian market and more recently, due to BHP's position as the world's largest diversified miner in a cyclical, global resource boom. Due to its weight in our indices we typically see that when BHP breaks to the upside, our broader market will usually run higher and when BHP breaks to the downside, our broader market will usually follow it lower as well. The momentum in BHP's stock price trickles down throughout the rest of the market and creates the BHP effect.

We can find evidence of the BHP effect in several ways. Firstly, we see a strong relationship between the highs and lows of BHP and the indices which it is part of. For example during 2011, BHP reached a high of \$49.81 on April 11, 2011 and hit a low of \$34.81 on August 9, 2011. The ASX200 index (XJO), hit a high for the year on April 11, 2011 at 4976 and hit a low for the year on August 9, 2011 at 3766. Fig. 1 shows this relationship between the XJO and BHP.

Fig 1.

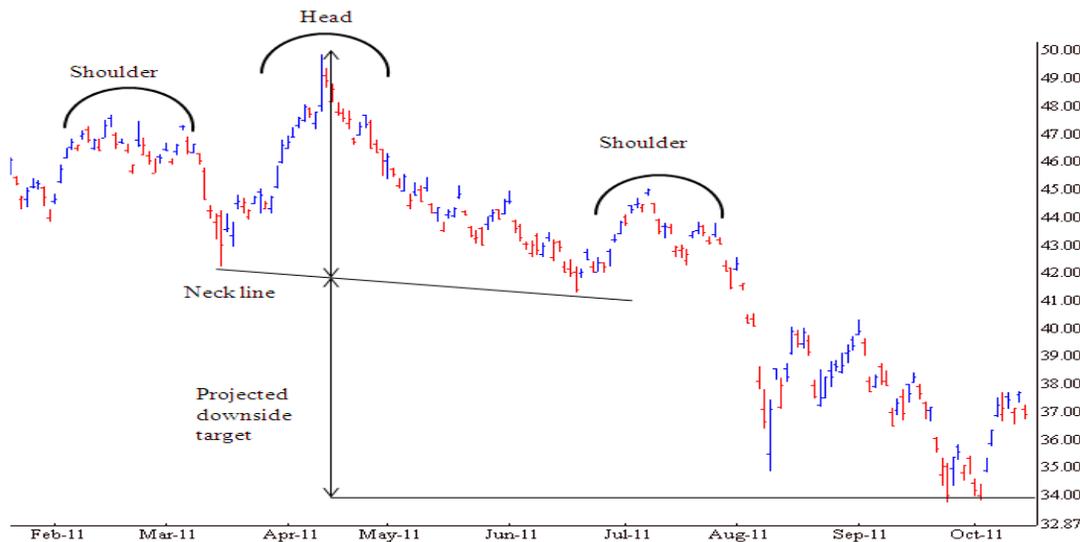


The XJO did not hit its high or its low for 2011 on the back of the price movement in BHP alone. It also had the help of the other 200 stocks in the index. But the BHP effect is so great that its price action often corresponds more closely with that of the XJO than any other stock. For example, the Commonwealth Bank (CBA), the second largest stock in the XJO by capitalisation with about a 7% weighting in the index had an intra-day, annual high in 2011 of \$55.70 in February but it was not able to move the XJO to a high point for the year in

February 2011 in the same way that BHP was able to lead the XJO to its annual high in April 2011. You can see that even if the second largest weighted stock in the index is bullish, as it was in February, it does not carry the same influence over the XJO as BHP.

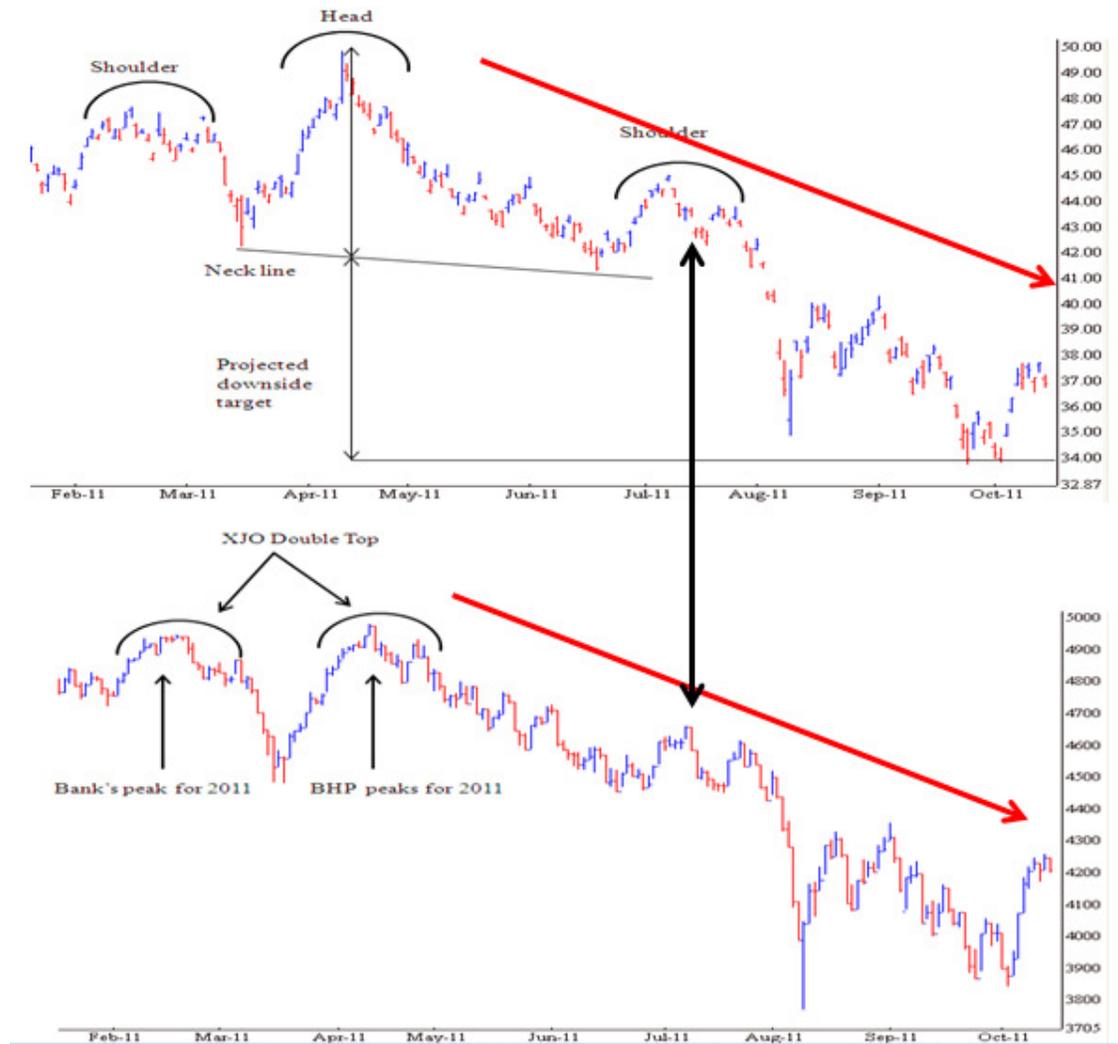
Therefore, as traders in the Australian market we need to be aware of the BHP effect because there is a crowd dynamic at play here. It could be subconscious, it could be conscious. In my case it's conscious because I use the relationship between BHP and the XJO as a tool to help guide my sentiment towards the broader market. For example, when BHP made a bearish Head and Shoulders pattern in mid-2011, I used it as a proxy for the future direction of the broader index and become bearish on the market and traded with appropriate caution.

Fig. 2



The XJO didn't precisely mimic BHP's head and shoulders pattern but it was very similar (see Fig. 2) for no other reason than the fact that there are other companies in the ASX such as the top four banks which are also influential. The top four banks are influential but only because their combined total weighting in the ASX200 is about equal to that of BHP. But on an individual basis, BHP is the sole leader of the indices. Due to major banks peaking in February and then BHP peaking in April 2011, we get a double top in the ASX200 in February and April 2011.

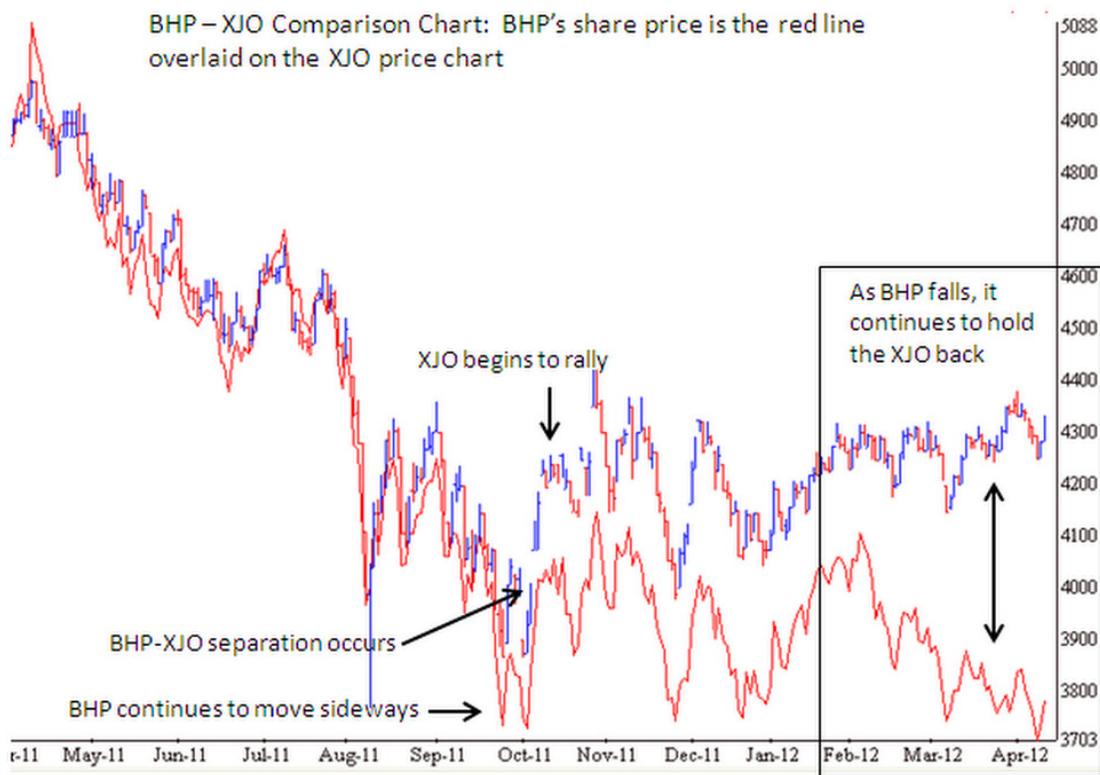
Fig. 3



Moving forward into 2012, the BHP effect is still being felt in our market. The XJO chart shows an ascending triangle pattern (see Fig. 3). This is typically a bullish pattern and we can expect to see resistance taken out and the XJO running higher as a consequence. But it is being held back by BHP which is acting like a dead weight or an anchor dragging behind the market, slowing it down.

In Fig. 4, you can see the relationship between BHP's performance and that of the XJO. They track each other nicely. But then in October 2011, we get a separation and since that time, the XJO has tried hard to move forward, but as you can see in the diagram, as BHP's share price declines, it continues to undermine or stifle the upward momentum of the broader index.

Fig. 4



The performance of BHP is a good barometer for the ASX200 for those looking to forecast the future direction of the index (including ETF traders). Traders who are aware of the topography between BHP and the XJO are able to use the BHP-effect to make longer term forecasts (like we showed when BHP was making a head and shoulders pattern) and to gain an insight and greater understanding as to why our market is struggling to capitalize on broader based bullish sentiment.

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